Carnegie Consulting

Strategic Solutions for Business

Diversification and Defending First-Mover Advantage

Prepared For:

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Executive Summary

During 2001, Countrywide had a banner year. Taking advantage of low interest rates, Countrywide was able to set company records for loan originations and servicing and to diversify further into other financial products and services.

Moving forward, however, Countrywide faces two challenges that threaten to undermine its long-term success. First, the mortgage banking industry is consolidating. Larger players are buying out smaller players, enlarging scale economies, and this consolidation puts increasing pressure on all players to grow larger. Larger firms will be able to challenge Countrywide's competitive advantage as the most efficient company in the industry. Countrywide is keenly aware of these trends and has been putting effective strategies in place to deal with them.

Second, the mortgage origination business is steadily transitioning from a brick-and-mortar operation to a bricks-and-clicks approach. Maintaining its market position in originations is vital to Countrywide's "macro-hedge" strategy and long-term financial health. As the mortgage originations business moves increasingly to the Internet, Countrywide will no longer be able to depend so heavily on its current competitive advantage with proprietary retail branches and broker relationships to initiate originations.

Consumers who decide to bypass third party brokers and shop for mortgages directly with Countrywide must first be aware of the company. Whereas everyone knows about lenders such as Wells Fargo, JP Morgan Chase, Washington Mutual, and Bank of America, consumer awareness of Countrywide is quite low. For this reason, Carnegie Consulting recommends that Countrywide commit itself to developing strong brand awareness with the general public.

Company Overview

Company History

New Yorkers Angelo Mozilo and David Loeb founded Countrywide Credit Industries on March 14, 1969. Mozilo and Loeb had worked together for 8 years at a small mortgage company prior to this collaboration. Mortgage banks at that time were normally small, localized businesses focused on residential niches and staffed by commissioned sales forces. However, Mozilo and Loeb envisioned a much larger mortgage company, one with a presence throughout the United States and so when they decided to start their own company they chose the name "Countrywide."[i]

Countrywide was not an immediate success. Following three largely unprofitable years, Loeb and Mozilo knew that to achieve their dream of becoming a nationwide mortgage company, a radical change was needed. They decided to completely restructure Countrywide. They fired their commissioned sales force and in its place began advertising to customers their market-beating rates and points. By cutting out the high-cost commissioned agents, Countrywide was able to immediately lower production expenses and charge lower rates to customers. This strategy, and other similar ones, allowed Countrywide to become the low-cost mortgage provider for the next 30 years. Within 10 years the company had expanded from a base in Los Angeles to over 40 branches in eight states.[ii]

From 1978-1982, interest rates soared to 18% and destroyed the traditional mortgage business. Countrywide realized that it must diversify its business. In 1981, Countrywide opened Countrywide Securities Corporation, which issued Countrywide labeled mortgage-backed securities for sale to investors. In 1984, Countrywide launched the Correspondent Lending Division to not only sell mortgages to other lenders but also to purchase them in the secondary market. The idea was that Countrywide would specialize in the servicing rights associated with the loans (collecting of loan payments, handling delinquent payments, etc.). They would do this by purchasing mortgages and subsequently selling them back in this market while keeping the servicing rights. Today, "Countrywide Securities Corporation" is one of the nation's largest securitizers of residential mortgage loans and Countrywide is one of the largest correspondent lenders.[iii]

The economy improved in the mid-1980's, and Countrywide took advantage of relatively low interest rates and corresponding increased numbers of refinancings and originations to resume fast growth. In 1985, Countrywide's share price increased from $2 to $12 due to increased earnings and diversification.[iv] In 1986, Countrywide formed a Wholesale Lending Division to fund mortgages generated by independent mortgage brokers. Countrywide now could acquire loans originated through mortgage brokers not part of the company and pay them a per unit fee. As is their norm, Countrywide has expanded this business and is currently one of the nation's largest wholesale lenders.

In 1985, Countrywide began purchasing servicing rights on a large scale from other mortgage lenders. It formed Countrywide Servicing Exchange to help broker these deals in 1989, and within three years this division was trading more servicing packages than any other company in the nation.

Interest rates began to fall again in the early 1990s, increasing the demand for mortgage originations and mortgage refinances. Countrywide's business grew very rapidly and, during its boom, it became the number one mortgage lender in the nation. Capital investments in computer systems installed beginning in the 1980s provided the company with economies of scale and allowed it to effectively handle a huge inflow of business. Artificial intelligence systems helped to speed loan approvals. These technologies allowed Countrywide to easily manage most of the servicing of these loans, and Countrywide became the U.S.'s largest loan servicer.

The late 1990s were characterized by Countrywide's further diversification and expansion into existing markets. The company launched a website in 1996, and as of March 2002, 47% of its loan originations involved direct Internet contact.[v] Countrywide also diversified into insurance, investments, and other financial services to complement its mortgage business. In May 1999, Countrywide went international with the opening of Global Home Loans. Global Home Loans is a joint venture with large UK bank Woolwich, who subsequently was bought by UK financial services leader Barclays, through which Countrywide has utilized its operational expertise and technology to become one of the largest processors and servicers of residential loans in the UK.[vi]

Mozilo remains as the Countrywide Chairman CEO, a position that he has been quoted as saying he has never even considered relinquishing.[vii] In fact, Mozilo recently signed a 10-year agreement with Countrywide that includes continuing as chairman, chief executive officer and president through 2006, and remaining on in a consultancy basis for an additional five years beyond that.[viii] And, due in large part to Mozilo's continued leadership, Countrywide's management looks to maintain the same focus on results and innovation moving forward that it has exhibited in the past as it became known as "a technology company that happens to be in the mortgage business."[ix]

Overview of Countrywide's Major Products and Services

Table 1

CONSUMER OPERATIONS

CONSUMER MORTGAGE ORIGINATIONS		32% of NI for FY 2001
Consumer Markets Division		
	Lends directly to consumers. Borrowers originate loans through proprietary retail branches, by telephone, or over the Internet	
Wholesale Lending Division		
	Lends to customers through network of nearly 15,000 mortgage brokers	
Full Spectrum Lending, Inc.		
	Lends directly to sub-prime consumers through 41 national branches	
Loan Closing Services		
	Offers array of closing services including appraisals, flood zone determinations, pre-purchase home inspections, escrow, etc.	
MORTGAGE RELATED INVESTMENTS		28% of NI for FY 2001
	Retains certain mortgage-related assets, which include capitalized mortgage servicing rights and residual interests	
	Manages servicing hedge designed to protect investments against prepayment risk	

BUSINESS-TO-BUSINESS OPERATIONS

CAPITAL MARKETS		16% of NI for FY 2001
Correspondent Lending		
	Purchases closed loans from mortgage bankers, commercial banks, and other institutions	
	Countrywide Warehouse lending provides warehouse letters of credit to mortgage originators to finance acquisition of residential mortgage loans	
Countrywide Securities Corporation		
	Specializes in trading and underwriting of fixed income products	
Countrywide Servicing Exchange		
	Brokers bulk servicing for 3rd parties and arrange mortgage servicing purchases for Countrywide Home Loans	
Countrywide Asset Management Corporation		
	Specializes in the purchase, acquisition, servicing, management, and disposition of residential mortgage assets including mortgage servicing rights	
PROCESSING AND TECHNOLOGY		11% of NI for FY 2001
Domestic Loan Servicer		
	Services $285 billion portfolio for Global Home Loans (as of Feb. 28, 2001)	
	Sub-services $8.6 billion portfolio for other lenders	
50% ownership of Global Home Loans		
	Services and processes loans for UK partner Woolwich (recently purchased by Barclays)	
COUNTRYWIDE INTERNATIONAL CONSULTING SERVICES		<1% of NI for FY 2001
	Provides advisory services to primary and secondary mortgage companies worldwide	

JOINT OPERATIONS

CONSUMER & B2B INSURANCE		13% of NI for FY 2001
Countrywide Insurance Services		
	Offers retail property and casualty insurance products to customers	
Balboa Life and Casualty and DirectNet Insurance		
	Serves insurance needs of institutional clients, business partners, and customers	

Source: Countrywide 2001 Annual Report

Internal Rivalry

Industry

Countrywide Credit Industries is primarily a domestic provider of diversified financial services for residential mortgage holders.

Product

Countrywide's services can be broken up into three groups:

Countrywide's consumer businesses include Countrywide Home Loans, Full Spectrum Lending, LandSafe, Countrywide Insurance Services, and Balboa Life and Casualty. Countrywide Home Loans is responsible for the origination, purchasing, securitization, selling and servicing of home loans. Full Spectrum lending specializes in the sub-prime residential market. LandSafe provides loan-closing services, which include appraisal services, credit rating, home inspection, flood certification services, and title services. Countrywide Insurance sells homeowner's, home protection, life, auto and disability insurance. Balboa Life and Casualty provides property, liability and life insurance.

Countrywide's business-to-business services include capital markets, processing and technology, and insurance products. Countrywide Capital Markets is a boutique investment bank specializing in mortgage-related products. DirectNet Insurance offers access to insurance products and services to institutions and professionals who want to offer insurance to their clients.

Countrywide's international operations mainly are conducted through its Global Home Loans joint venture with Barclay's subsidiary bank Woolwich, plc. This subsidiary expands Countrywide's home loan servicing to the United Kingdom and other European countries. Recently, Countrywide has also built a small team of mortgage professionals to offer international consulting services to primary and secondary mortgage companies worldwide. This division currently conducts market assessments, develops strategic and business implementation plans and provides management expertise.

Geography

Countrywide's primary business focus is the United States. For its home lending business, Countrywide offers nearly 500 branches nationwide.[x] To supplement these branches, Countrywide has a network of over 15,000 domestic mortgage brokers that it works with to fund additional loans. In order to allow borrowers availability at any domestic location, Countrywide also offers a comprehensive website that offers online customer service, loan servicing, and preliminary loan origination forms. Countrywide's concentration of branches is largest in Southern California. However, Countrywide has gradually expanded throughout the years and is now moving global with operations initiated in the UK through its Global Home Loans subsidiary.

Rival Firms

Countrywide's major competitors are large, diversified financial institutions, including banks and thrifts. Countrywide is the fourth-largest loan originator:

Table 2

TOP 2001 Loan Originators (Calendar 2001)		
Top Originators	2001 Loans ($billion)	Market Share
Wells Fargo	$194.4	9.3%
J.P. Morgan Chase	$184.2	8.8%
Washington Mutual	$175.5	8.4%
Countrywide	**$138.2**	**6.6%**
Bank of America	$82.4	3.9%

Source: *Countrywide Credit, Inside Mortgage Finance – March 26, 2002 – Bank of America's Securities Presentation*
Note: Washington Mutual's portfolio size omits the impact of its acquisition of Dime in January 2002

Countrywide is the fourth-largest loan servicer:

Table 3

2001 Loan Servicers (Calendar 2001)		
Top Servicers	Portfolio Size ($billion)	Market Share
Washington Mutual	$496.7	8.6%
Wells Fargo	$487.8	8.5%
J.P. Morgan Chase	$429.8	7.5%
Countrywide	**$336.6**	**5.8%**
Bank of America	$320.9	5.6%

Source: *Countrywide Credit, Inside Mortgage Finance – March 26, 2002 – Bank of America's Securities Presentation*
Note: Washington Mutual's portfolio size omits the impact of its acquisition of Dime in January 2002

Herfindahl Index

Herfindahl Index analysts consider an industry to be concentrated if its value is above 1200, and highly concentrated if the value is above 1800. An index of 1200 roughly equates to a market of 8 equally sized firms (12.5% market share each), and an index of 1800 to a market of 5 equally sized firms (20% market share each). The magnitude of industry concentration is important because if concentration is sufficient, firms may exercise market power and price products above marginal cost. The Herfindahl index is calculated by summing the squared market shares of all firms in the Industry. From Table 2, the Herfindahl index in loan origination is between 293-437 (depending on the breakdown of the market shares of the minor players).[xi] No single company has greater than a 10% market share, and the low Herfindahl suggests that firms in this industry do not possess significant market power. Similar conclusions apply in the loan-servicing sector as the Herfindahl index is between 267-630.[xii] To the extent that mortgage originations are a local phenomenon, where the market might be better defined as a Metropolitan Statistical Area (MSA) rather than a national one, Herfindahl indexes for major standard areas would be considerably higher. The asset-based Herfindahl index for commercial banks in MSAs average about 2000.[xiii]

Differentiation from Competitors

Mortgage lending is essentially a commodity business. Lenders price loans based principally on the bond market (an example being the 30-year mortgage rate which tracks the 10-year treasury bond rate since the duration of the 30-year is sufficiently less than 30 years and allows for the two to serve as close substitutes).[xiv] And, loans with the same rates, durations, and points, are regarded as virtually the same by borrowers.

Countrywide's principal competition, commercial banks and thrifts, differentiate themselves to mortgage customers through brand awareness and by cross selling multiple relationships. These depository institutions can target existing customers of savings, lending and transactions services. They can also compete for mortgage business from the general public by offering the convenience of large numbers of branches. Banks and thrifts offer consumers the convenience of routine banking services and mortgages at the same place.

Countrywide, by contrast, competes against banks and thrifts in two ways. Most importantly, Countrywide competes through specialization in mortgage products and services. Through this specialization, Countrywide is able to operate more efficiently and at a lower cost than its diversified banking/thrift rivals. Countrywide thoroughly understands its businesses and through its focus on innovation is able to leverage large economies of scale in operations. As Alan Boyce, Countrywide Analyst and Portfolio Manager at George Soros, notes: "Countrywide is run by a bunch of accountants who are awesome at cutting costs and being efficient; they are better than everyone at it."[xv] Secondly, Countrywide tries to differentiate itself based on customer service. The effort has paid off. J.D. Power and Associates recently ranked Countrywide number one in customer satisfaction among the largest national home mortgage lenders.[xvi] Countrywide is capitalizing on this distinction by touting its honor in a national television ad campaign. Said Countrywide Managing Director of Marketing Andy Bielanski, "Because this is the first J.D. Power and Associates' award ever given to a mortgage lender, it gives us a unique opportunity to set ourselves apart from the competition."[xvii]

Strategies

Countrywide's long-term strategy has been to focus on what it does best, originating and servicing loans, doing it at the lowest cost, and providing excellent customer service.

During the last ten years, however, Countrywide has shifted strategies and is now in the process of becoming a diversified financial services company as Countrywide seeks new lines of business that will help the company meet the diverse financial needs of its mortgage holders. As Mozilo, the company's CEO, has said: "Our company is in the midst of a dramatic and far-reaching transformation."[xviii] Today, almost half of Countrywide's earnings are generated from businesses that did not exist a decade ago. Examples are the company's operations in the business-to-business insurance and banking markets, capital markets, and the European mortgage market.

Regulation

Countrywide is subject to less regulation than its major bank and thrift competitors. Countrywide's major competition, principally large banks, thrifts, and credit unions, are subject to strict regulation. As depository institutions, the U.S. Government provides their customers deposit insurance up to $100,000 per account. In exchange for this insurance, depository institutions are regulated. The government does not want to have to pay for deposit defaults so it monitors these institutions for "safety and soundness." If depository institutions are found to be engaged in practices that are too risky, then the regulator demands safer practices, and if the depository institution does not comply with these demands, then the regulator has the power to replace management and the board, and even to take them over.[xix]

Countrywide is at a disadvantage to banks and thrifts due to this regulation and governmental support. This regulation allows banks and thrifts to borrow at lower rates from lenders. Lenders lend money to banks at lower rates because they know that the government regulates them and that depository insurance basically ensures that the bank will not fail.[xx] Countrywide, on the other hand, must rely on its audited financial statements and credit ratings to prove its reliability to lenders. But, financial statements can be ambiguous and credit ratings are known to lag business operations or be inaccurate, so lenders typically charge Countrywide higher rates on loans than they do for banks. Higher costs of funds relates directly to the bottom line as it decreases Countrywide's margins. In addition, banks are able to take advantage of government support and lower costs of funds to borrow more money and increase the leverage in their servicing portfolio. Banks typically leverage their servicing portfolios at 8-1, while Countrywide currently only leverages their own at 2-1.[xxi]

Substitutes and Complements

Complements

Countrywide's principal product is home mortgage loans. Home mortgage loans provide a base and a point of contact with customers that allow mortgage loan providers to offer complementary products and services.

The most direct and obvious complement to home mortgage loans is loan servicing. Mortgage lenders acquire the rights to service the loan once the loan is closed and have the power to decide whether they either want to service the loan or sell off its servicing rights.

The majority of mortgage purchasers are young families not at a point yet in their lives where they are large investors in stocks and bonds, but they are consumers of insurance.[xxii] Therefore, although the only direct insurance complement to home mortgages would be homeowner's insurance, through economies of scope associated with Countrywide's existing relationships with its customers, all types of insurance may be included as complements to home loans including health, life, and car insurance.

Products and services that increase the value of home ownership, or that can be provided with lower transactions costs at the time of the purchase or sale of a home, can serve as complements to mortgage loans. Products and services that fall into this category include loan closing services including appraisals, credit reporting services, flood zone determinations, pre-purchase home inspections, title searches, escrow and closing documentation.

Substitutes

There are few practical substitutes for a mortgage for most homebuyers. A small fraction of the population may be able to self-finance the purchase of their home, their only consideration being whether their capital would yield returns in excess of the mortgage loan rate. Another equally small group may be able to finance through a third party, such as an employer (e.g. Pomona College). For those without unique options or considerable financial wealth, renting and leasing are the main substitutes for a mortgage. However, many if not most renters are likely, at some point in their lives, to purchase a mortgage.

Barriers to Entry

The mortgage banking industry has experienced significant consolidation in recent years. In terms of loan origination, the top 5 loan originators now control about 37% of the origination business versus only about 12.5% in 1992.[xxiii] Consolidation has been similar in the loan servicing business where the 5 largest servicers hold a 36% market share versus approximately 10% in 1992.[xxiv] Much of this increased consolidation has resulted from mergers and acquisitions. Some examples of major acquisitions include Washington Mutual's recent acquisition of North American Mortgage Co. and PNC Financial Services and Wells Fargo's acquisition of Norwest.[xxv]

Although barriers to entry are typically low in the mortgage banking business, barriers to entry have increased as consolidation has occurred. During periods of falling interest rates, loan production may be exceptionally profitable and firms can enter the market. However, to engage in loan servicing, and stay in the business through rate cycles, a firm must be large, as effective loan servicing requires great efficiency and tremendous economies of scale. Managing servicing risk takes a high level of expertise and it is easy to get "burned."[xxvi] Throughout the 1970's, Citicorp was the largest and most successful mortgage lender, but the company had huge losses in the early 1980's and soon afterwards exited the industry.[xxvii] In order to compete in loan servicing, servicers must have the size to take advantage of large economies of scale in order to reduce costs. This size requirement, coupled with the inherent risk involved in the industry, provides a significant barrier to entry for smaller and even larger players. And, with consolidation, barriers to entry have increased, as firms need to increase investments in technology, in physical plants, and in building successful sales and marketing efforts to achieve the economies of scale and scope being realized by their rivals.

As consolidation continues, de novo entry into the mortgage lending business of any substantial size is unlikely. Due to the volatility of the industry and the increased economies of scale and scope, it is predicted that only the most technologically advanced and deep-pocketed firms will survive.[xxviii] In fact, it is rumored that even major players Chase and Bank of America may not be happy in the market and may exit.[xxix] However, one potential threat that exists in the private mortgage market is the increased participation of Fannie Mae and Freddie Mac who have recently been "making inroads into everything and encroaching into the private sector."[xxx] Fannie Mae and Freddie Mac are huge companies. These firms have expertise in the mortgage market, typically act in sequence, are immensely levered, and have substantial government support. Therefore, moving forward, Fannie Mae and Freddie Mac may pose significant threats to the current private mortgage sector.

However, outside of the entrance of Fannie Mae and Freddie Mac into the private mortgage market, Countrywide welcomes consolidation in both the short and long-term. As Stan Kurland, president of Countrywide Home Loans says: "Overall, consolidation has been very good for us."[xxxi] Countrywide believes that its competitors' acquisitions have served to dilute "brand awareness" of the acquired firms and sidetrack the mortgage lending activities of the surviving institutions for much of the post-acquisition year. Countrywide uses Washington Mutual's acquisition of three of the best mortgage lending brand names in California to illustrate this point (Great Western Bank, Home Savings of America, and American Savings Bank). And, in the longer term, Countrywide welcomes industry consolidation, as the company believes that as market concentration increases, so will profit margins.

Buyer and Supplier Power

Buyer Power

Buyer power is defined as the ability for buyers to lower an item's price. Home mortgage borrowers are Countrywide's principal buyers. To the extent that the mortgage lending business is a commodity business, buyers search out and differentiate loans based almost solely on rates. Borrowers are typically unorganized and exhibit little bargaining power. However, although overall buyer power can be described as weak, buyers who are refinancing or are only considering the purchase of a home, have more collective power when interest rates are higher. When interest rates are higher, borrowers can take their time with regard to accepting a loan. The longer a borrower waits, the higher the probability that rates will go down, and borrowers may use this knowledge to better negotiate mortgage rates from lending companies.[xxxii] When interest rates are low, borrowers have little if not zero power as potential borrowers flock to lending companies in order to lock in low interest rates and are even willing to sacrifice an 1/8 of a point or two in order to lock in a rate before interest rates go back up.[xxxiii]

In the secondary markets, Fannie Mae and Freddie Mac are the primary purchasers of Countrywide's mortgage securities. Fannie Mae and Freddie Mac command approximately 55% of the secondary market.[xxxiv] Given this dominant position, Fannie and Freddie can exhibit buyer power and manipulate the price of the traded securities.

Supplier Power

Supplier power is defined as the ability of suppliers to negotiate prices that extract industry profits. Countrywide depends upon two principal suppliers. The first supplier is the mortgage broker. Mortgage brokers initiate loans by quoting rates to individual borrowers and then searching for corresponding rates from mortgage lenders to fund the loan, i.e. brokers search for the lender who is offering the lowest rate so that they can maximize their spread. In this sense, mortgage brokers are price takers. Mortgage lenders post mortgage rates and then mortgage brokers either accept the existing rates or renegotiate rates with the borrower. Hence, mortgage brokers do not have supplier power because their fees are not dependent upon the interest rate but rather the spread that they pass on to the borrower. In addition, mortgage brokers are losing share of originations in the mortgage lending business as a whole as more and more of the lending process is automated or available through the Internet.

Countrywide's second group of suppliers is its suppliers of servicing rights in the secondary market. Although Countrywide is a seller in this market (because it does not hold mortgages on its balance sheet), Countrywide is also a buyer of mortgage servicing rights once the particular loans have been securitized. As introduced above, Fannie Mae and Freddie Mac are dominant players in this market and can exhibit supplier power as they move together.

Strengths, Weaknesses, Opportunities and Threats

Strengths

Management

Countrywide's greatest strength is its core management team. Countrywide has been led for the last 32 years by "mortgage pioneer" Angelo Mozilo. During this time, Countrywide management has demonstrated flexibility, resilience, and superior strategic decision-making while successfully riding out the ups and downs of the mortgage business. Since the first several years of Countrywide's existence when it failed to make a profit, Countrywide management has exhibited the capability to make pivotal decisions and the resilience to survive and to thrive. This capability continues today and looks to continue tomorrow as Mozilo has agreed to continue as CEO and President through 2006, and has positioned around himself a team of four Senior Managing Directors, each focused on distinct operational areas, with over 60 years combined Countrywide experience.[xxxv]

Mozilo asserts: "We aim not to withstand change but embrace it."[xxxvi] All this management capability is demonstrated quantitatively by Countrywide's current income streams and the fact that nearly one-half of Countrywide's current earnings are derived from business lines that didn't exist at Countrywide ten years ago.[xxxvii] Eying opportunities in markets complementary to its mortgage loan offerings, Countrywide has been able to rapidly and efficiently vertically integrate and expand into new markets such as B2B insurance and banking markets, capital markets, and overseas. As Alan Boyce, Portfolio Manager at George Soros, puts it: "These guys are experts at turning cost-centers into profit-centers and vertically integrating."[xxxviii]

Macro-hedge Strategy

Outside of management, one of the other major strengths that Countrywide possesses is a specialization in two businesses (origination and servicing) that have a negative correlation with regard to the company's major risk factor, fluctuating interest rates. That is, the fluctuations from originations and servicing move in opposite directions, so the drop of one is theoretically balanced out by the increase of the other to some degree. Insiders at Countrywide call this balance its "macro-hedge strategy." This macro-hedge is powerful in that it serves to help protect the company from servicing risk, the risk associated with losing assets from the servicing portfolio when interest rates fall and a large number of existing loans are refinanced.

The following example shows how the macro hedge works. Assume that there is a $100,000 loan with a 7% mortgage rate. The 7% is what the borrower pays to the lender and this 7% is broken into 6.5% for the owner of the loan and .5% for the servicer of the loan. The difference between 6.5 and .5 creates a yield of 50 basis points of which, on average, 40 bps go to the servicer who collects payments on the loan and handles delinquencies, etc. (the rest goes to Fannie Mae or Freddie Mac for providing a guarantee on the loan). For the servicer, 40 bps equates to $400 on a $100,000 loan and the servicing rights on the loan are tradable. Due to the average duration of a 30-year loan, servicing rights are normally valued at 5-6 multiples when the loan is originated or $2000-$2400 (5-6 x $400) in this example.

The servicing right on this loan has a value of $2000-$2400, when the loan is originated. However, if the borrower decides to refinance and pay back the loan when mortgage rates fall, then the value of that servicing right asset goes to 0. This is what is known as servicing risk. Countrywide currently services approximately 3.3 million loans with a principal balance of $330 billion.[xxxix] On average, each of these loans has a servicing value of $2000. This means that at any time, Countrywide has a 2000*3.3 million=$6.6 billion servicing asset which theoretically could go to zero value very quickly. During a refinancing boom caused by low interest rates, Countrywide's servicing portfolio loses significant value as more and more people refinance their loans. In a typical year, 10 percent of borrowers refinance or pay back their loans. In a refinance boom, it is possible that as many as 50 percent refinance, creating a loss of $3.3 billion in the servicing portfolio.

To hedge this risk, Countrywide is also in the business of loan origination. When someone refinances, they not only close their original loan but they also originate a new loan. Countrywide's macro-hedge is its ability to acquire more loan originations during refinance booms than it loses from its servicing portfolio. Although it is no guarantee that Countrywide will get all of its loans back from people who are refinancing, Countrywide does in fact get most of them and even acquires a lot from other lenders. On average, due to Countrywide's superior market position and gains in market share, Countrywide acquires 1.5 times as many loans as it loses during these periods.[xl] So, continuing with the example above, Countrywide produces $14 billion in new loans and has $9-10 billion in runoff per month during a refinance boom so their portfolio grows by $5 billion and $5 billion off of an asset of $330 billion per month is about a 20% annual return. Moreover, not only is volume up in a refinance boom, but so also is the profit margin. Normally, a loan originator gets 50 bps profit for originating a loan. However, in refinance boom where demand for loans is high, the average margin increases to 100 or 125 bps (partly due to the low recapture costs of old borrowers who are refinancing).[xli] This increased margin combined with a positive 1.5x turnover on loans provides a solid hedge against the 200-240 bps the servicing portfolio loses due to the refinancing (1.5 x 125=187.5 which is close to the 200-240 lost). In fact, since probably at least a few years of the mortgage payments will have already been collected on the average loan before it is refinanced, the bps lost on the refinance may be even closer to a perfectly balanced 190 bps.

On a loan-to-loan basis, then, regardless of interest rate declines, Countrywide is able to create new value through origination, which to some degree offsets the lost value from the servicing portfolio. And, as Jeff Speakes, Managing Director of Risk Management at Countrywide, says: "That is the power of our business model, that the two business that we are best at are inherently negatively correlated so as to mitigate risk."[xlii]

However, although the macro-hedge is still valuable, in practice this macro-hedge does not work nearly as well as it does in the example above. To compensate for this inefficiency, Countrywide manages a "huge" financial hedge focused on providing high returns when interest rates fall to compensate for servicing portfolio losses. Alan Boyce describes this hedge as the "real Countrywide hedge" and this financial hedge is described below under the section: Threats – Servicing Risk.[xliii]

Loan Servicing

Countrywide is very good at providing top-line loan servicing at a low-cost. Its servicing portfolio grew by approximately 24% in 2001, and has grown annually at 28% for the last 10 years.[xliv] This strength comes from a focus on automation and technology. Richard DeLeo, Managing Dirctor of Domestic Loan Administration, says: "We believe we have the most efficient mortgage servicing operation in existence."[xlv] Countrywide focuses constantly on process improvement and automation in all functions. Much of Countrywide's customer service has been moved to the Internet or to automated telephonic prompting. With automation comes economies of scale. Countrywide has leveraged this servicing expertise and scale not only domestically but also internationally through its Global Home Loans subsidy and through its partnership with Woolwich. In addition, due to Countrywide's continued organic growth, as opposed to other competitors' acquisition related growth (ex. Washington Mutual), Countrywide has a distinct advantage to its competitors because its servicing is run from a single platform as opposed to multiple platforms where absolute economies can not be gained.

Countrywide's expertise in servicing and the advantages that come along with it extend into the secondary mortgage market as well. Due to its servicing efficiency (ability to service loans at a low cost), Countrywide is able to maintain larger margins than its competitors. Given these margins, Countrywide is capable of profitably outbidding competitors when purchasing loan-servicing rights and extracting greater profits, i.e. Countrywide is able to pay higher prices to obtain servicing rights and acquire more servicing rights than others because it has higher margins and can service these loans less expensively than others.

As noted above, a strong servicing capability is important because it serves as a natural hedge to the loan production cycles and protects the company from servicing risk. In addition, the servicing portfolio is valuable because when rates increase, less people prepay, and the servicing portfolio typically grows. In this manner, the servicing portfolio balances company earnings to at least some degree when interest rates increase and the number of originations fall.

Countrywide's servicing strength is also valuable because servicing is the part of the business where Countrywide has the most contact with customers and the ability to build long-lasting and rewarding relationships. Out of these customer relationships, Countrywide has been able to successfully launch numerous complementary products and services such as insurance and loan closing services.

Weaknesses

Brand

Carnegie Consulting has concluded that Countrywide has not fully exploited its branding potential. Marketing expenditures decreased during fiscal year 2001 from $72.9 million in 2000, to $71.6 million.[xlvi] The percentage decrease due to these nominal values was approximately 2%. As described above, offering mortgage loans is largely a commodity market. Bond markets determine the rate that lenders will set for mortgage rates and, therefore, there is little differentiation between the rates that top lenders will set. However, although a mortgage may not be differentiated based upon price, advertising and branding of mortgage loans still is important. Carnegie Consulting believes that as the Internet becomes more and more a part of the mortgage lending process, mortgage loans will become "search goods," i.e. goods that consumers can find on their own. As people begin to shop for rates and submit loan applications online, it will become vital for mortgage companies to have a brand identity. Countrywide does not look as if it is expending enough resources in order to motivate people to look first at Countrywide for mortgage loans, especially when its major competitors are big names such as Wells Fargo and Washington Mutual. This weakness will worsen as more and more loans are originated from initial consumer contact with lenders on the Internet rather than through traditional mortgage brokers and retail branches. In order to succeed moving forward, Countrywide needs to be in the "evoked set" of mortgage companies that most consumers shop when they begin their search for a mortgage.

Size & Lack of Regulation

A competitive, inherent weakness for Countrywide is that Countrywide is not regulated, nor nearly as large and diversified as many of the commercial banks and thrifts that it competes against: Washington Mutual, Wells Fargo, Chase, and B. of A. As discussed above, banks are government regulated and, therefore, are able to take advantage of lower costs of funds to fund loan originations. In addition, given that these competitors have immense assets, have their deposits insured, and have lower costs of funds to finance more liquidity, these banks have the ability to significantly financially leverage themselves in the mortgage market. And, as stated above, Countrywide's depository competitors often leverage their servicing portfolio up to 8:1, while Countrywide is only able to leverage their portfolio at 2:1.[xlvii] Countrywide, being solely focused on mortgages, does not have the resources to be able to take on the additional risk associated with increased leverage and, therefore, is unable to take advantage of enhanced leverage like the banks.

Opportunities

Purchase of a Bank

In May 2001, Countrywide diversified further by becoming a bank holding company with the acquisition of Treasury Bank. There are several strategic initiatives associated with this purchase. First of all, Countrywide believes that through economies of scope, a bank can effectively sell complementary services to Countrywide's existing 3 million mortgage customers and 500,000 insurance customers and better meet customer needs. Secondly, this purchase allows Countrywide to further diversify away from its concentration of cyclical mortgage operations. Beyond the obvious diversification effects of a bank's wide variety of products and services on the company's cyclical nature, a bank also will allow Countrywide to more effectively engage in portfolio lending, whereby it can originate and hold adjustable rate mortgages (ARMs), instruments that are more popular when interest rates rise.[xlviii]

Thirdly, and potentially most importantly, a bank will allow Countrywide to lower its cost of funds. As bank deposits grow, Countrywide will be able to take advantage of these deposits as an inexpensive means to lend funds. In addition, as discussed in the Regulation Section above, due to its mandatory regulation as a depository institution and its related arguable "impossibility of failure," Countrywide will be able to borrow money from lenders at a lower rate.[xlix] This discount may even approach 100 basis points as Mark Cooper, Director of Research at the Consumer Federation of America, suggests.[l] And, finally, an increased asset base, government supported stability, and lower costs of funds, will allow Countrywide to increase the financial leverage of its servicing portfolio and reap the benefits. For these reasons, and other potential ways Countrywide can utilize the bank to further vertically integrate, Countrywide's acquisition of Treasury Bank provides large opportunities moving forward.

International Expansion

Countrywide's state of the art operations and technology to process and service loans more efficiently, provides ample opportunities for Countrywide overseas. Recognizing these opportunities, Countrywide created Global Home Loans (GHL), and partnered with Barclay's large UK bank Woolwich. Countrywide provides GHL with the technology and operational expertise to handle Woolwich's entire loan processing and servicing. Most of these services are automated services and have huge economies of scale. However, admittedly, GHL is still in its infancy and is learning a lot from this initial move overseas.[li] Still, GHL grew by 74.1% in 2001.[lii]

There are ample opportunities for Countrywide to continue its international expansion. With regard to Global Home Loans, GHL has the platform and capability to rapidly expand and take advantage of opportunities outside of the UK and with other banks. GHL needs to be to continue this growth. As introduced above, Countrywide has also begun an international consulting operation through a small team of mortgage professionals focused on providing mortgage expertise to international institutions for a fee and using these relationships to identify potential partners and opportunities. This consulting team has already or is currently engaged in projects in Japan, Korea, Singapore, Mexico, and Columbia. These relationships should prove valuable as Countrywide continues to expand internationally. In addition, Countrywide, as Global Home Loans subsidiary grows and matures, will have the opportunity to vertically integrate products and services complementary to the home loans to international mortgage owners much like they have done in the domestic market. There are vast opportunities for Countrywide to expand internationally and it appears that Countrywide has an operational base and legitimate strategy moving forward to take advantage of these opportunities.

Threats

As discussed briefly above, the two main sources of risk for the mortgage industry are the servicing business risk and the interest rate risk:

Servicing Risk

As discussed above, servicing risk is partially hedged through its macro-hedge. However, the success of the macro-hedge is largely dependent on the ability of Countrywide to continue adding 1.5 loans for every one loan that it loses during periods of prepayment influxes. Countrywide is currently able to maintain a return ratio of 1.5 due to its strong position in the mortgage market and its market share advances. But, if Countrywide's position in the origination market or other assumptions given in the example above change for the worst, Countrywide may face serious potential threats to its financial health.

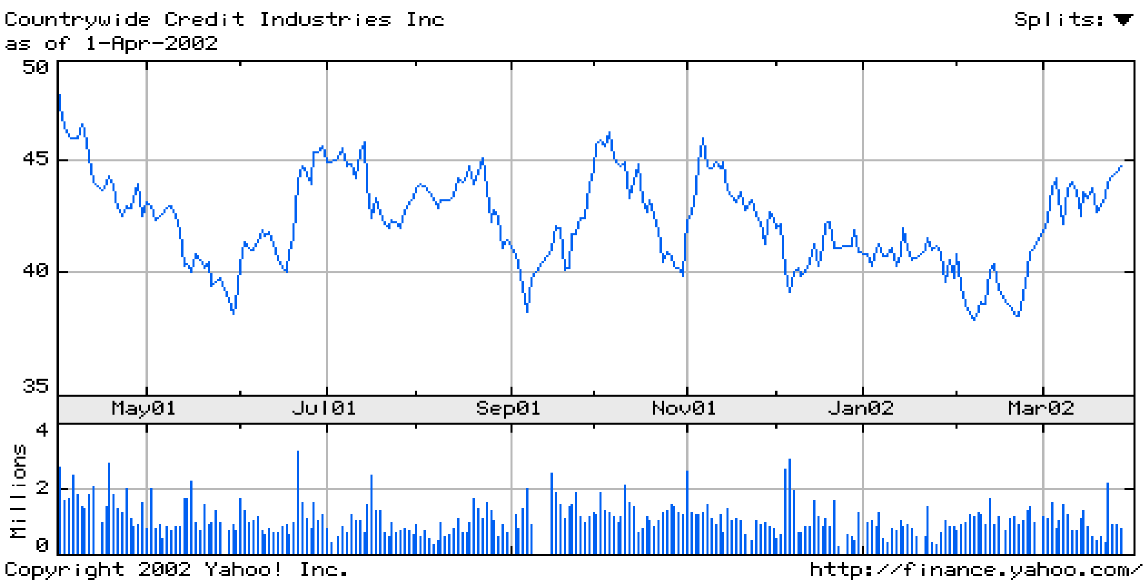
Due to these flaws in the macro-hedge, Countrywide manages a "huge" financial hedge to ensure that there is a significant hedge against servicing risk when interest rates fall and there is a high level of prepayments. In fiscal year 2001, this Servicing Hedge resulted in an enormous net benefit of $797.1 million.[liii] Jeff Speakes, Managing Director of Risk Management at Countrywide, heads this team. In this hedge, his team looks for and finds instruments that have large gains when interest rates fall but only small losses when rates rise.[liv] In order to maintain this position, Speakes' team purchases mainly optional positions, including financial instruments such as interest rate floors, principal only securities, options on interest rate swaps, options on mortgage-backed-securities, options on rate futures, and interest rate swaps. As stated above, the goal of these positions and ultimately the hedge is designed to protect the value of the mortgage servicing rights from the effects of increased prepayment activity that is normally associated with decreasing interest rates. So, when rates fall, and the mortgage servicing rights lose value, this hedge provides instruments that can be exercised at a huge gain to compensate for the loss. On the other hand, if rates increase, the value of the mortgage servicing rights increases while the value of the servicing hedge instruments decline. But, since the majority of these positions are optional positions, when rates increase the company only loses to the extent of its initial outlay to acquire the optional instruments. This hedge provides Countrywide with a sound instrument to protect itself from the potentially devastating effects of servicing risk.

Interest Rate Risk

Interest rate risk is minor but still exists at Countrywide. Interest rate risk involves the issuing of a loan at a particular interest rate and then having interest rates rise unexpectedly. Due to rising interest rates, the present value of the loan payments is no longer worth as much as much as when the mortgage was issued. Countrywide currently, on average, holds loans for 30 days before they are sold on the secondary market.[lv] Therefore, Countrywide is subject to interest rate risk on their loans during this 30-day period. Countrywide manages this interest rate risk by entering into "hedging transactions."[lvi] In more detail, Countrywide efficiently eliminates the interest rate risk for these loans by engaging in forward contracts for the sale of the loans.

Financial Outlook

Countrywide's recent stock performance has been disappointing given the company's outstanding earnings performance and below-industry average P/E of roughly 11.5.[lvii] The stock has been trading in a range between $38 and $46 for much of the year:



Countrywide announced net earnings for the third fiscal quarter that ended November 30, 2001, to be $1.27/share, up 59% from the 3rd quarter the previous year.[lviii] In addition, Countrywide's Board of Directors declared a cash dividend of $.10 per share for the third quarter.

Growth was outstanding during the quarter on all levels. Led by low interest rates and strong performance from the production sector, Countrywide funded 26% more loans than they did in the previous quarter and 139% more than they did over the quarter the year before.[lix] The correspondent, mortgage broker, and retail divisions all broke records for production at $15.1 billion, $13.8 billion, and $13.4 billion for the quarter.[lx]

The servicing portfolio also continued on its powerful growth trend. Through 11 months in 2001, the servicing portfolio was already 18% larger than the portfolio for the year before. This is even more impressive given that servicers normally face many difficulties in periods of low interest rates due mainly to increased rates of loan prepayment which reduces future servicing income on the loans to zero. Originations more than made up for these losses in the servicing portfolio as fundings exceeded prepayments by $17.4 billion in quarter and increased the service portfolio by $17.4 billion[lxi]

The company predicts that it will follow this quarter up with a similar quarter of earnings of between $1.27-$1.32. CEO Mozilo is upbeat in the release: "Although the recent increase in interest rates may signal a decline in refinance activity, we remain very optimistic about overall growth prospects for the company."[lxii] On a longer-term outlook, analysts agree with Mozilo and expect Countrywide to have an aggressive annual growth rate of 14.5% for the next 5 years.[lxiii]

Countrywide appears to be undervalued. It has 14.5% estimated forward growth and is trading at a P/E of approximately 11.5, which is at a discount to other lenders in the market who have lower expected growth rates. Two potential reasons for this low valuation are Countrywide's relatively high debt-equity ratio and their apparent dependence on low interest rates for stable earnings growth. These issues are addressed in the Strategic Analysis section below.

Strategic Analysis

Summary

Countrywide is in a strong position. Financially, Countrywide had a record year in terms of loan originations, servicing, and its other diversified financial products and services. There appears to be little internal rivalry between the principal lenders and the focus of the market seems to be on expanding it and diversifying as opposed to taking origination market share away from each other. Currently, it appears that interest rates are set for a moderate incline upward but should stay relatively low for at least the near future.[lxiv] This additional time will allow Countrywide even more time to prepare for higher interest rates by building out its services outside origination which play as a hedge to balance earnings when interest rates rise. Countrywide management has a history of making good business decisions and Carnegie Consulting foresees a strong move by the company toward initiating an even stronger presence on the Internet and on the Global Scope as a mortgage loan and service provider.

Analysis of Critical Issues

Debt Ratios

Typically, mortgage companies have high debt/equity ratios and Countrywide is no different. Countrywide's current debt/equity ratio is 3.73.[lxv] On the surface, this looks ratio seems pretty high. However, Countrywide, in a practical sense, is not nearly that levered. This high leverage ratio is due in large part to a timing problem associated with accounting during refinance booms such as the one that the economy is in currently. The problem occurs due to the accounting recognition disparity between the large loss that is recorded when the company is forced to immediately write off the present value of the servicing rights to a loan when a borrower refinances versus the minimal gain on the production side of only the origination fee that is received during that quarter when the same person per se originated their new loan. Hence, this refinance and loan origination appears on the books as if the company has just taken a huge loss when actually nothing significant in economic terms has changed since the loan origination (and the associated servicing rights) is worth just as much economically as the original servicing rights. So, although Countrywide's servicing portfolio based on current accounting standards is leveraged at about 2:1, it is actually less than that ratio in economic terms.

With regard to the leverage of the balance sheet outside of the servicing portfolio, Jeff Speakes notes that "if the company wanted to, it could reduce the warehousing (the holding of the loans) to zero days instead of the normal 30 days."[lxvi] That switch would wipe out all of the liabilities on that side of the Balance Sheet, and leave the company only with the debt associated with its servicing portfolio. Speakes expresses further confidence in the financial stability of the company by mentioning that the company is even considering increasing the leverage ratio of the servicing portfolio above its current 2:1 level.

Although a 3.73 D/E may appear daunting and may actually have a negative impact on the stock price, the true leverage (in economic terms) of the company is lower. For this reason, and the company's flexibility in handling the timing of the sales of loans in the secondary market, the company does not appear to be in any danger of loan default. In addition, it is not prudent to forget the history of the company and realize that the company has been running itself with the same sort of financial ratios for over 30 years through good and bad climates and has still persevered. Moving forward, assuming that Countrywide continues to move toward becoming a bank, it is notable that banks typically are much more levered than the current Countrywide.

Employee Inflow and Outflow

Due to a need for increased numbers of loan originators and processors during refinance booms, there is a large inflow of employees into large mortgage firms when interest rates drop and once the booms are over, there is a large outflow of employees. Managing this inflow and outflow is difficult. However, Countrywide seems to have "learned by doing" with regard to solving this problem.

Jeff Speakes admits that although it is still a "roller coaster" at times, as more refinance booms have gone by, Countrywide has been getting better and better at managing these people.[lxvii] During 2001, Countrywide did not open or close a single branch when the refinance boom hit. Instead, the firm hired 3,000 temps and short-term employees and placed them throughout their retail branches.[lxviii] Part of the solution is due to increased automation efficiencies including Countrywide's improved online customer service and automated telephone prompts that allow processors and servicers to increase their productivity and handle increased numbers of loans. Another part of the solution is due to Countrywide's market share of the purchase business getting larger which makes the refinance booms more stable because the purchase business is tied to the new home sales cycle as opposed to more volatile interest rates.[lxix] This market share aids Countrywide's stability during booms because if it has a large enough share of purchase, then it already has enough branches to handle the influx of refinancings when interest rates decrease, and the company does not have to open and close branches. Branches are expandable and contractible (sales and processing) and although managing and training a group of temps is a challenge, it is a part of the mortgage business and the temps are prepared for the up and down swings. In fact, Speakes notes that there is even a group of temps that come in during the booms who are mortgage professionals who just move from mortgage cycle to mortgage cycle.[lxx]

Diversification

A focus and strength of Countrywide has been its ability to diversify its operations in order to help mitigate the effect of interest rate fluctuations on earnings performance. Through its origination and servicing platforms, Countrywide has been able to leverage existing relationships with consumers, real estate agents, and financial institutions, to increasingly cross-sell related products and services. In recent years, Countrywide has successfully added non-mortgage-centric businesses, such as insurance and banking. Management believes the combination of these and related efforts will favorably position Countrywide to thrive in a post-refinance boom environment.

The insurance division is booming. Last year, net income from the company's insurance divisioned ballooned from 6% of net income in 2000, to 13% in 2001.[lxxi] Originally, Countrywide Insurance Services marketed property, casualty, and life insurance to mortgage customers. But, two years ago Countrywide acquired Balboa, an insurance carrier focused on meeting the insurance needs of financial institutions, and since has exploited the synergies between the two with Countrywide Insurance Services's powerful retail sales force and Balboa's ability to design product and market coverage to institutional investors. Continued high growth in this division is expected and its growth as a percentage of the company's net income is important since it can provide a strong balance for the company swings due to rate fluctuations.

As discussed above, Countrywide became a bank holding company with the acquisition of Treasury Bank in May 2001. Treasury Bank has already experienced tremendous growth and by 2006, Countrywide hopes to expand out its banking products and services to approximately 25% of net income.[lxxii] Banking products and services are less tied to interest rates as traditional mortgage banking products and services, and will act as a significant driver of balanced growth moving forward as its composition of net income increases.

Countrywide is working to mitigate its susceptibility to interest rate fluctuations. As of 2001, 22% of Countrywide's earnings were produced outside of their mortgage banking operations, principally the production and servicing.[lxxiii] Countrywide recently has produced extremely strong growth in its Insurance, Capital Markets, Global, and even its small Banking venture. Countrywide expects this growth to continue moving forward. And, by 2006, Countrywide expects to have only 50% of their earnings come from mortgage banking.[lxxiv] In addition, as discussed above with regard to interest rates fluctuations, the continuous growth of Countrywide's servicing platform has and will continue to serve as a natural counterbalance to the fluctuations in originations. Moving forward, Countrywide clearly is successfully working to lessen its dependence on rate fluctuations.

Strategic Recommendations

Expansion

Carnegie Consulting's concludes that Countrywide is extremely well-positioned in its industry and is poised for future growth as it expands through its existing channels into the complementary opportunities that have been discussed in this analysis. Beyond this position, however, Carnegie Consulting believes that there are two exceptional opportunities that need to be Countrywide's focus moving forward.

The first opportunity is to expand Countrywide's bank. As discussed above, Countrywide is currently at a significant competitive disadvantage to its large competitors who can acquire funds at a lower cost and leverage themselves higher. Expanding out its bank and providing its existing customers with complementary banking products will allow Countrywide similar advantages. Another one of Countrywide's inherent problems is its sporadic cash flow due to rate fluctuations that forces investors to use high risk premiums when assessing the company's valuation, i.e. high risk premiums due to earning's uncertainty. The addition of a significant and stable income stream from its banking entity will provide Countrywide with more earning's stability and work to decrease the large risk premiums that investors currently use to value the stock. If this banking venture is successful, both improved earning's stability and increased income growth through increased leverage and higher margins, will improve shareholder value. In addition, the inherent stability of a bank due to government regulation and support should increase Countrywide's valuation by further reducing its risk premium.

The other significant opportunity for Countrywide moving forward is its impending global expansion. Currently, Countrywide, thorugh its Global Home Loan subsidiary, has the platform to scale and rapidly expand its processing and servicing services throughout Europe. In addition, through Countrywide's international consulting operations, Countrywide is building relationships with foreign mortgage-related institutions that potentially can be negotiated into business relationships such as the one with Barclay's Woolwich. These international operations, both the international consulting and the processing and servicing, are high margin operations with the potential for high growth moving forward. Countrywide needs to maintain focus on these areas and through their growing expansion as a portion of Countrywide's net income, these operations should work to increase shareholder value.

Online Branding

In 2001, 47% of Countrywide's originations involved Internet contact. This number is up significantly from 2000.[lxxv] In the 3rd quarter of 2001, Countrywide utilized the Internet to fund $3.5 billion of mortgage loans.[lxxvi] That number is more than three times the number of the nearest competitor, Washington Mutual, who only originated $1.1 billion of its loans involving online channels.[lxxvii] Clearly, Countrywide is the early favorite in this online market. However, the impact of the Internet in driving originations is only going to continue growing, and more competition is going to enter the market. It is Carnegie Consulting's position that it is vital for Countrywide to maintain its early dominant online position both through increased website functionality and brand development. As mortgages transition more and more into "search goods" online, a dominant brand will be even more important as there will be tremendous opportunities to gain market share from competitors. But, to do this, Countrywide needs to invest heavily in developing improved brand recognition. It is Carnegie Consulting's position that heavy expenditures on marketing and advertising in the coming several years during the transition online will more than pay off in the long-term as Countrywide is able to establish itself as the premier online, low-cost mortgage leader.

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